Global Equity Views

Themes and implications from the Global Equity Investors Quarterly

2Q 2021

IN BRIEF

- Corporate profits are recovering rapidly around the world, led by the U.S. and China. We think that profits will continue to grow strongly and outpace expectations, although we need to watch out for higher taxes and inflation as the potential costs of the pandemic response.
- Equity markets have delivered robust returns this year as profits have surged, but high valuations temper our enthusiasm. Speculative activity has moderated in recent weeks—a healthier sign. But the gap between cheap and expensive stocks remains very wide, suggesting plenty of opportunities for stock selection.
- Three themes from our recent investment quarterly:
  - Some mega cap technology stocks remain attractive even as value investing enjoys a renaissance.
  - Paying attention to environmental, social and governance (ESG) factors can help returns, and we think the trend will continue.
  - U.S. small cap stocks appear to be set for further outperformance.

TAKING STOCK

The recovery in corporate profits from a brief but pronounced collapse in mid-2020 has accelerated since our last Investors Quarterly, exceeding our expectations to a striking degree. A year ago, we thought that 2021 profits would remain below pre-pandemic levels. We now see results at least 10% higher. The companies that had been seen as most likely to adapt to the COVID-19-driven shutdowns have not disappointed, and the technology sector has done better than we expected. But the real surprise has been the resilience and subsequent rebound for many of the groups most affected by the pandemic.

The word cloud in **EXHIBIT 1** broadly captures the views of our investors.

Our latest forecast of USD 2.6 trillion for 2021 profits across developed markets is almost USD 200 billion higher than three months ago. Upward revisions are very broad-based, but industrial-cyclical companies (experiencing robust demand and higher energy prices) and financials (benefiting from lower loss reserves and buoyant capital markets) stand out as particular areas of strength.

Although growth will slow, the remarkable profits boom seems likely to continue for a while. Interest rates are extremely low, and central banks are in no hurry to change that, despite growing signs of inflation (many of our analysts note strong pricing power for the companies they follow). Massive fiscal stimulus should further fuel the recovery. Consumer balance sheets are in excellent shape, and companies are struggling to keep up with demand. We see another strong

AUTHOR

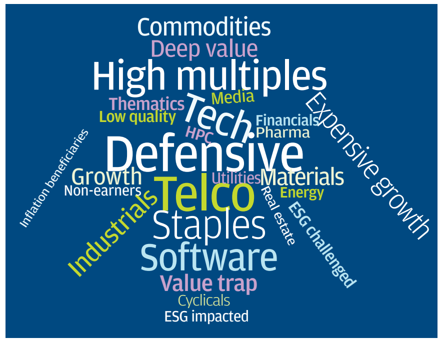
Paul Quinsee
Managing Director and Global Head of Equities

Views from our Global Equity Investors Quarterly, April 2021

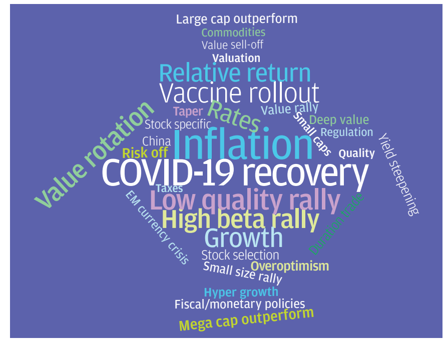
EXHIBIT 1

BEST OPPORTUNITY GLOBALLY?

WORST OPPORTUNITY GLOBALLY?



BIGGEST RISK GLOBALLY?



A subset of results is shown for a survey of Global Equity Investors Quarterly participants taken in April 2021. These responses are taken from a quarterly survey representing 38 CIOs and portfolio managers across global equities.

year of profits growth in 2022, with Europe and parts of the emerging world catching up as pandemic conditions fade. Higher corporate taxes appear likely as the bill for stimulus spending comes due, but the overall picture for corporate profits is exceptionally strong.

Of course, markets have recognized much of this good news. High valuations across global markets moderate our return expectations considerably. Valuation metrics are all strikingly high, save for comparisons between equities and fixed income, which are still supportive despite the rise in bond yields this year. The development of inflation and the speed of central bank response in that event will be key issues to watch.

Meanwhile, speculative activity within the equity markets persists, although it has cooled a little of late. For example, many special purpose acquisition companies (SPACs) have lost ground, and enthusiasm has faded for buying shares of companies that have never made a profit. Globally, the 170 companies we follow that have never been profitable have lagged by around 10% this year, after a staggering 70% outperformance in 2020. Valuation differences between low and high priced stocks remain extremely wide, despite the sustained burst of enthusiasm for many beaten-down cyclical companies since "Pfizer Monday" last November (**EXHIBIT 2**).

THEMES FROM OUR INVESTORS QUARTERLY

Some big growth stocks still look reasonably priced

After compounding at 20% returns for a decade, the leading technology companies represent an unusually large proportion of equity indices. In the U.S., the top 10 names account for almost 30% of the value of the S&P 500. Is this a classic bubble? We're not so sure. For a start, these companies are exceptionally profitable, as evidenced yet again by a stunning set of earnings reports this quarter. Microsoft, for example, is generating more than USD 1 of free cash flow for every

2020 was a record year for stocks with fast growth but no profits. 2021 looks different

EXHIBIT 2A: RELATIVE RETURN, HIGH SALES GROWTH

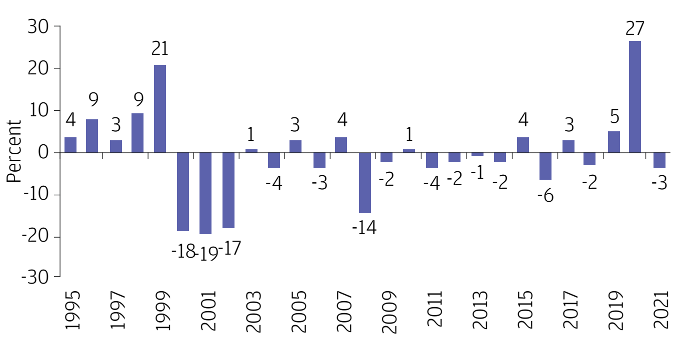
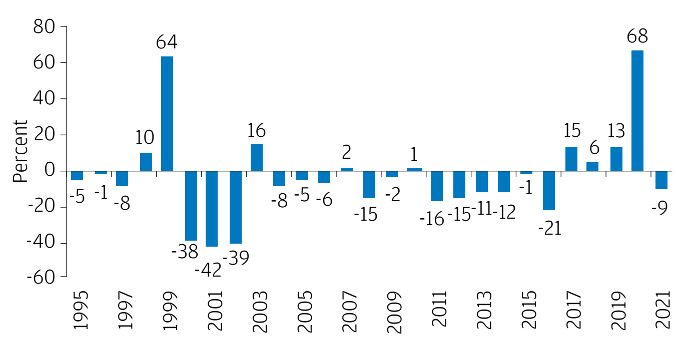


EXHIBIT 2B: RELATIVE RETURN, EBIT-UNPROFITABLE COMPANIES



Source: FactSet, IBES, J.P. Morgan Asset Management; data from December 31, 1994, to March 31, 2021. Charts show the active returns of the top quintile portfolio relative to the equally weighted universe, gross of transaction costs. Portfolios are constructed in the Behavioral Finance global all cap investible universe.

USD 3 in revenues. Rarely if ever have we seen such remarkable profitability at this scale. And the growth trends driving these profits look set to continue for many years to come. Cloud computing still accounts for less than 20% of technology spending; 50% seems a plausible medium-term target. As a result, these stocks should continue to deserve their premium valuations for the foreseeable future.

Of course, not all growth stocks are created equal. Software profits look more durable to us than earnings for hardware, such as smartphones. And while the valuations of the biggest companies seem broadly rational, we note some clear areas of excess in mid cap stocks and some of the most popular investment themes. Consider: At least five electric vehicle companies have projected USD 10 billion of revenues within seven years of earning their first dollar. The current record for this achievement, held by Google, is eight years, making these claims in aggregate highly implausible. But overall, many of our portfolio managers favor a balanced approach, investing in both long-term winners and the newly popular beneficiaries of the recovery in the industrial and financial sectors, something we highlighted in our last quarterly note.

Paying attention to ESG can help returns

Our investment team now has several years of experience both in integrating ESG factors into our investment process and in managing dedicated strategies with a focus on sustainability. What have we learned? We see evidence that understanding these factors helps returns. In the emerging markets, for example, companies lagging in ESG metrics have trailed ESG leaders by around 5% a year and shown more volatility as well.

In developed markets, we see similarly persistent, if less pronounced, poor performance of ESG laggards.

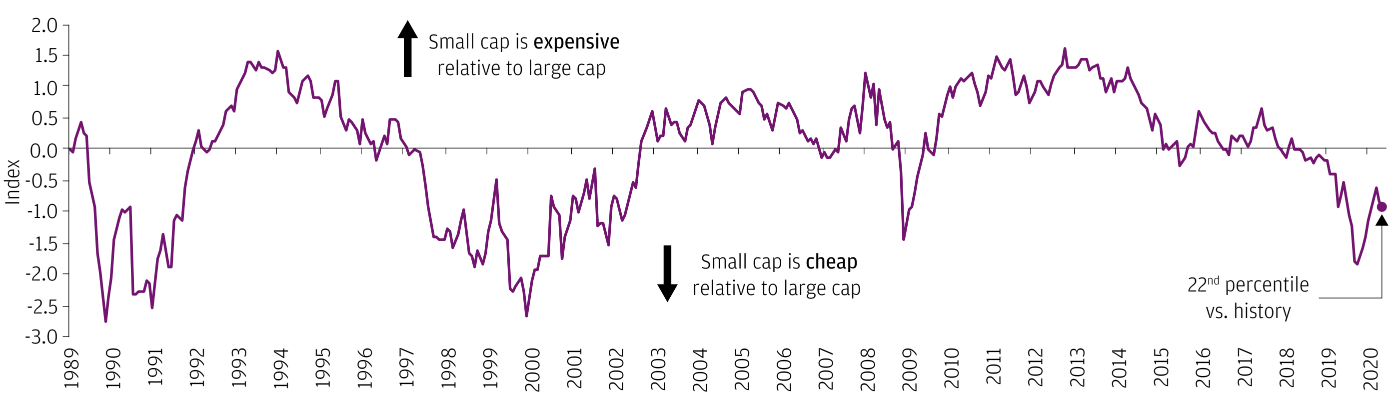
Has the market simply created a bubble in ESG investing? Overall, there is now a clear premium for companies with more attractive sustainability scores. ESG leaders trade at a 2 point P/E premium across the developed markets, and more in the emerging world. While there are some undeniably expensive stocks associated with the most obvious and popular themes, we think these premium valuations are generally justified by better current profitability and growth prospects. In short, we don't see a bubble here. And ESG funds have attracted plenty of interest recently, especially in Europe, but don't yet appear large enough to have distorted the pricing of stocks across equity markets.

Small cap outperformance has further to run

After almost 10 years of relatively subdued performance, small cap indices have been reinvigorated in recent months, helped by greater exposure to the dynamics of economic recovery. In the U.S., more than 80% of the profits of companies in the Russell 2000 are derived from the now red-hot domestic economy. We see a good chance that this renewed enthusiasm for smaller companies will persist; our research finds the valuation of small caps vs. large caps to be more attractive now than in almost 80% of the last 30 years. Within the small cap market, we see the same trends we find elsewhere, but here they're more pronounced, and recovery from recession is very much the theme of the moment. In particular, higher quality attributes have been ignored of late—a typical pattern in a rapid recovery, and one that is unlikely to persist. Our investors are beginning to again add higher quality names to the reliable long-term outperformers in the small cap space (**EXHIBIT 3**).

Small still attractively valued relative to large

EXHIBIT 3: VALUATION SPREADS OF RUSSELL 2000 INDEX VS. RUSSELL 1000 INDEX



Source: J.P. Morgan Asset Management. Data is based on a composite of proprietary valuation factors for stocks in the Russell 2000 Index vs. the Russell 1000 Index; data are from December 31, 1989, to March 31, 2021. The performance quoted is past performance and is not a guarantee of future results. For illustrative purposes only.

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- Partner with one of the world's leading equity managers and benefit from our ***long history of innovation*** and success.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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